

Output tax apportionment

(Lecture B1164 – 12.48 minutes)

If a business did not claim any input tax when it bought an asset (or goods) because it wholly related to exempt activities, then the good news is that no output tax is payable when the item is sold in the future. The sale is exempt from VAT by virtue of VATA1994, Sch 9, Group 14 – Supplies of goods where input tax cannot be recovered. This situation would also apply to the onward sale of a motor car where input tax was blocked on purchase because the vehicle was available for private use.

However, a twist to the tale is that if the asset was used for both exempt and taxable purposes, i.e. a proportion of input tax was claimed as residual input tax, then output tax is still chargeable on the full selling price. This is not such a good deal – 100% output tax being paid on the selling price but less than 100% claimed for input tax purposes.

Example 1

Janet trades as a financial services adviser, so is partly exempt for VAT purposes.

She purchased a computer three years ago and only claimed 50% input tax under the partial exemption standard method (residual input tax) because the item was used for both taxable and exempt activities. She bought another computer at the same time and claimed no input tax because it wholly related to exempt use. Each computer is now being sold for £1,000 – how much output tax is payable?

Answer – the partial input tax claim means that output tax is due on the full selling price of the first computer i.e. $£1,000 \times 1/6 = £166.67$. But no output tax is due on the sale of the second computer because input tax was wholly blocked when it was purchased.

Private or non-business use

When input tax is blocked on the purchase of goods because there is partial or total use for private or non-business purposes, this part of the asset is being taken out of the business. So when it is subsequently sold, there is no output tax to declare on the same percentage. This outcome is particularly important for many charities, which often have non-business and business activities, but also many commercial organisations as well.

Example 2

Sean the builder bought a van for £5,000 plus VAT last year and only claimed input tax on 80% of the expense and he blocked the other 20% as being relevant to private use. He is now selling the van for £3,000 plus VAT.

Sean will want to ensure he does not overcharge VAT on the sale because it is possible the buyer might not be able to claim input tax. Output tax is charged on 80% of the selling price i.e. $£3,000 \times 80\% \times 20\% = £480$.

Flat rate scheme (FRS)

An important exception to the rules considered so far relates to the FRS. The sale of assets is always included as flat rate turnover if no input tax was claimed on the purchase of the item. As an example, if a VAT registered accountant who uses the FRS sold his business motor car for £3,000, he would not charge VAT on the sale to the buyer but must still account for FRS tax of £435 on the sale i.e. £3,000 multiplied by the 14.5% FRS percentage for accountants. There is no partial exclusion for private use. However, if he bought an asset and claimed input tax because the total cost exceeded £2,000 including VAT (allowed for scheme users – see VAT Notice 733, para 15.2), then he would charge his customer 20% VAT and fully account for output on his VAT return i.e. the sale is excluded from FRS turnover.

Reference: VAT Notice 733, para 15.9.

Mixed supplies

Imagine that a business owns a boat that can accommodate 30 passengers and it charges passengers a single fee of £50 for a two-hour boat trip that also includes a hot meal and wine. The boat trip is zero-rated because it carries more than ten passengers (VATA1994, Sch 8, Group 8, Item 4) but the catering supply is standard rated. How much output tax should be declared within the £50 selling price?

The key point is that there is no specific method set in law that must be used – the legislation states that any method can be adopted, as long as it gives a fair and reasonable result (HMRC Notice 700, para 8.1.1).

A logical way of approaching this challenge might be to look at the cost of items that are bought by a business, and work out the standard-rated percentage, which is often an easy method when goods rather than services are involved in a mixed supply situation.

In the case of the boating supply, does the business offer customers the same trip but without any catering? If so, it would be 'fair and reasonable' to treat the same amount as relevant to the ride within the £50 price for the trip that also includes food and drink. The balance of the payment would then be standard rated as relevant to the supply of catering.

Example 3

Janet is a book retailer and she sells a standard rated pen and zero-rated book for a single price. There are two possible methods of apportioning the output tax:

If Janet also sells the book as a single item, she could treat this selling price as the zero-rated element within the pen and book package (or vice versa for the standard rated value of the pen).

If she only buys in and sells the book as part of a pen and book package, she could base the standard rated element of her selling price according to the VAT charged by her supplier on the items in question. However, there is an element of danger with this approach – each business is responsible for deciding how much output tax it should charge on its supplies and not rely on third parties e.g. suppliers.

Incidental sales

Don't forget that if a business sells two items that are subject to different rates of VAT, but one of the items is 'incidental' to the other (i.e. a minor part of the deal) then VAT is wholly payable based on the rate that applies to the main item. For example, if our boat owner charges £40 for a boat ride, and the price includes a free cup of tea and a biscuit, it is reasonable to conclude that this is not a separate supply of catering but an incidental benefit to the customer to enhance his enjoyment of the boat trip. The sales proceeds are wholly zero-rated.

Common error

As a final twist, output tax apportionments need to ensure there is no confusion between VAT exclusive and VAT inclusive prices i.e. the difference between 20% and 1/6 in the calculations. Errors need to be corrected going back four years, which is good news for the overpayments but not such good news if an underpayment has occurred.

Example 4

Janet from the previous example buys a particular book for £7 per copy and a pen for £2.50 plus VAT, which she sells for £20 as a single package. She has decided to apportion her output tax based on cost prices. The standard rated ratio based on cost is 30% i.e. £3 divided by £10 (i.e. the relevant figure for the fraction is the VAT inclusive price of the pen) so output tax to declare on each sale is $£20 \times 30\% \times 1/6 = £1$. The standard rated cost price includes VAT in the calculations because the selling price of £20 also includes VAT.

Reference: VAT Notice 700, para 8.1.

Contributed by Neil Warren